ANALYSIS OF THE MANUFACTURING INCENTIVES INTRODUCED IN TURNER'S MAY 8, 1972 BUDGET

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Taxation and Fiscal Policy Branch,
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Analysis of the
Manufacturing Incentives
Introduced in Turner's May 8, 1972 Budget

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SUMMARY

The federal budget (May 8) introduced two permanent corporate tax incentives directed at the manufacturing and processing sectors of the economy. The measures are a CIT rate reduction on manufacturing and processing income plus a 2-year fast write-off for new investment in machinery and equipment used in manufacturing. These interacting measures constitute a powerful tax incentive package which will have major impact on industrial activity in Ontario and on provincial revenues.

Immediate Effects

- The new incentives will not have a large scale immediate impact because of the lag in investment response and the January 1/73 effective date for the CIT rate reduction. Benefits to corporations are unlikely to exceed $90 million in Ontario and $150 million in Canada in the 1972 calendar year.

- Turner's incentives should restore business confidence, by removing the uncertainty about DISC and by coming down solidly in favour of private sector expansion.

Long-Run Effects

1. Tax Savings to Corporations ... Estimated tax savings to Canadian corporations could exceed $700 million in 1973 ($600 million federal, $120 million provincial). This aggregate tax saving will rise to about $800 million in 1974 and gradually settle back in 1975 and future years. Ontario corporations will enjoy total tax savings of some $400 million in 1973, rising to $460 million in 1974, and tapering off thereafter. (These are tentative estimates which could be reduced if the final legislation is more restrictive than suggested in the May 8 budget).

2. Response to DISC ... The two interacting incentives constitute a major change in Canada's corporate tax structure which should neutralize the recent U.S. moves (DISC and 7 per cent investment tax credit) and strengthen the competitive position of Canadian manufacturers. It is interesting to note that Turner's initiatives in the use of corporate taxation would not have been possible had the federal government proceeded with integration of corporate and personal taxation.

3. Bonus to Ontario ... Benefits from the new incentives will accrue largely to the Ontario economy because of its large share of manufacturing activity. The new measures may also weaken existing regional incentives such as DREE because benefits go to profitable operations rather than marginal operations.

4. Structural Shifts ... The selective nature of the CIT incentives will encourage manufacturing and processing relative to other ineligible activities and sectors such as trade, services, agriculture and resources. This will tend to draw increased resources into manufacturing and away from these other sectors, thereby altering the future growth and employment patterns within Ontario's industrial structure.

5. Factor Shifts ... The fast write-off will encourage substitution of capital for labour inputs and advance technological applications. This will improve manufacturing efficiency, but may also reduce the future growth in permanent jobs in manufacturing.

6. Industrial Concentration and Foreign Ownership ... The companies most able to exploit the new incentives will tend to be highly profitable, large and expanding companies, many of which are foreign controlled. This implies an increase in industrial concentration and an increase in the non-resident share of future expansion of manufacturing in Canada and Ontario.

Revenue Loss to Ontario

- The CIT rate reduction will not cause a revenue loss to Ontario. Rather, the federal rate cut opens up room for a future increase in Ontario's taxation of corporations.
- The 2-year fast write-off, on the other hand, automatically entails a revenue loss to the Province unless we legislate not to parallel this new CCA provision. On the basis of the May 8 budget statements, Ontario's CIT revenue loss is estimated at almost $70 million in 1973, rising to over $80 million in 1974, then falling back to the $75 million range in 1975 and 1976.

I CORPORATE TAX RATE REDUCTION

Turner's new taxation policy includes a selective cut in the CIT rate on Canadian manufacturing income. Effective January 1, 1973, the federal CIT rate on such income will be reduced to 30 per cent. As part of Bill C-259, the federal tax rate was scheduled to decline by 1 percentage point annually, from 40 percent in 1972 to 39 per cent in 1973 and so on down to 36 per cent in 1976. Consequently, manufacturing and processing income will receive a permanent tax benefit compared to other types of income starting from a 9-point spread in 1973 and continuing at a 6 point spread from 1976 onward.

The new preferential rate for manufacturing income is also integrated in consistent fashion with the existing CIT incentive for small businesses (i.e. income under $50,000). The lower CIT rate available to small businesses (25 per cent) will be reduced to 20 per cent in the case of manufacturing and processing income.

The revised schedule of corporation income tax rates is shown in Table 1. Ontario's rate is assumed to remain at 12 per cent, though there is obviously new scope to increase the provincial rate. The combined rate on income over $50,000 which will apply in 1973, therefore, will be 51 per cent on income generally and 42 per cent on manufacturing and processing income. By 1976 the combined rate on income generally will decline to 48 per cent, leaving a permanent 6-point spread in favour of manufacturing.

The revised income tax legislation will set out specific rules to distinguish manufacturing and processing income from other income. The new rate reduction will, in fact, be a special "manufacturing income" <u>deduction</u>, similar in concept to the SBI deduction from the general corporate tax. The tax calculation for a manufacturing company with $100,000 taxable income would be calculated as shown in the following example.

Table 1

CORPORATION INCOME TAX RATES ON INCOME OVER $50,000

	Income Generally							Manufacturing & Processing Income			
	1967	1970	1972	1973	1974	1975	1976	1973	1974	1975	1976
Federal Rate	40	41.4[1]	36.5[2]	39	38	37	36	30	30	30	30
Ontario Rate	12	12	12	12	12	12	12	12	12	12	12
Combined Rate in Ontario	52	53.4	48.5	51	50	49	48	42	42	42	42

1. Includes the effect of the 3% surtax.

2. Includes the effect of the 7% reduction calculated on 50 points.

Note: Taxable income under $50,000 qualifies for a reduced rate. Prior to 1972, a dual general rate existed where the first $35,000 of taxable income was taxed at 21% and income over $35,000 at 50%. The tax reform Bill C-259 provides for a small business incentive deduction (SB1) leaving an effective rate of 25% on $50,000 of business income of Canadian-controlled private companies until their accumulated taxable income reaches $400,000. This SB1 deduction is augmented by a further 5% on manufacturing and processing income as per May 8 Budget.

CALCULATION OF TAX

Taxable income of $100,000 @ 49% tax rate			$49,000
Less deductions of: SBI @ 24% of $50,000	=	12,000	
"Manufacturing income" deduction of 9% of excess of $50,000 (SBI)	=	4,500	
"Manufacturing income" deduction of 5% of $50,000 (SBI)	=	2,500	
Equals total general tax			30,000
less 10% provincial abatement			10,000
Equals federal tax			20,000
Ontario corporation income tax			12,000
total federal and provincial income taxes			$ 32,000

Estimated Revenue Loss

There is no revenue loss to the Ontario Government from this federal rate reduction. The revenue loss to the federal government resulting from the rate reductions on manufacturing and processing income is estimated at $150 million in Ontario and $290 million in Canada in 1973. This loss will decline to $145 million in Ontario and $265 million in Canada in 1976. These estimates are the value of the CIT rate reduction in isolation of the interaction with the fast write-off provision; the new CCA provision cuts the loss from the rate reduction by reducing taxable income.

II TWO-YEAR FAST WRITE-OFF PROVISION

Effective May 9, 1972 the cost of all machinery and equipment purchased for the purpose of manufacturing and processing in Canada can be written off in two years; up to 50 per cent of the asset in the first year and the unclaimed balance in any subsequent year. With a normal level of profit a corporation could be expected to claim the full 50 per cent in the first year. This fast write-off provision has been designed to allow for variations in profits from year to year so that in a year of low profits a corporation would choose to write-off less than 50 per cent in order to maximize its tax position.

A new asset class will be established for these investments. This replaces the general depreciation rate of 20 per cent on a declining balance method (e.g. class 8 assets, machinery and equipment). It also replaces the 115 per cent federal provision for new property acquired by a manufacturer or processor after December 3, 1970 but before April 1972.

The federal government appears to have room for adjustments by defining "manufacturing and processing" investment which qualify for the fast write-off, and by defining manufacturing and processing income which qualifies for the reduced CIT rate.

Advantage of the Fast Write-Off

The use of fast write-off or accelerated depreciation instead of the declining balance method results in a greater flow of internal funds generated with respect to any given amount of depreciable assets. For any one asset the increase in cash flow (i.e. profits after tax plus depreciation) in the asset's early years over that resulting from the use of diminishing balance depreciation will be exactly offset by the reduction in cash flow in the later years of the asset's life. Where assets are acquired in successive years, however, the use of accelerated in lieu of declining balance depreciation will result in an increase in cumulated cash flow, until the taxpayer completely writes off his depreciable assets.

The acceleration of depreciation allowances should increase a firm's demand for depreciable assets and expand its financial capabilities for acquiring them.

Additional CCA to be Claimed under Fast Write-Off

The additional CCA to be claimed under the fast write-off is presented in Table 2 assuming that corporations claim 50 per cent in the first year and 50 per cent in year 2. As seen from this table, the fast write-off provides additional CCA in the first two years of asset's life. However, in subsequent years no depreciation will be claimed under the new fast write-off while there would have been if the asset were depreciated on a declining balance method. The total additional CCA to be claimed in any year will always be positive as long as new assets are acquired each year. And it is the total additional CCA in each year which is the relevant figure on which to estimate the revenue loss from this incentive.

Comparison of Three Recent Corporate Tax Incentives

The new CCA provision is much more effective as an incentive than the 115 per cent write-up it replaces, but less of a corporate stimulus than Ontario's 5 per cent investment tax credit. Clearly, any type of credit mechanism has a greater tax savings advantage because it is a reduction from tax whereas a mechanism such as CCA adjustments are deductions from taxable income before any rate is applied. Based on Ontario's 12% CIT rate, the net after tax cost reduction of an asset depreciated and claimed under the three incentives would be as follows:

Additional CCA write-up of 15% of cost (not adopted by Ontario)	0.4%
5% Investment Tax Credit	5.0%
Fast two-year write-off	3.6%

ADDITIONAL CCA TO BE CLAIMED UNDER THE FAST WRITE-OFF PROVISION
($ Million)

	CCA IN ONTARIO						CCA IN CANADA					
	Eligible M & E Investment	1972	1973	1974	1975	1976	Eligible M & E Investment	1972	1973	1974	1975	1976
1972	633 (7 mos)	190	216	-81	-65	-52	1206 (7 mos)	362	410	-154	-124	-99
1973	1195		359	407	-153	-122	2275		683	774	-291	-233
1974	1315			395	448	-168	2502			751	851	-320
1975	1446				434	492	2753				826	936
1976	1590					477	3028					908
YEAR TOTAL		190	575	721	664	627		362	1093	1371	1262	1192

The estimates of increased CCA to be claimed assume that manufacturing investment in manufacturing and equipment will increase by 10 per cent per year.

Revenue Loss from Write-Off Incentive

The fast write-off is the more powerful of the two CIT incentives introduced by Mr. Turner. Moreover, the resulting revenue loss is substantial to provincial treasuries as well as to the federal government.

The Ontario Corporation Tax Act automatically includes this fast write-off provision unless Ontario legislates against it. If Ontario should parallel this incentive, the resulting revenue loss is estimated at about $20 million in 1972. This is based on the current level of investment intentions, only 7 months of which will qualify in 1972. In 1973 and 1974 when the incentive is fully effective and working to stimulate increased investment, Ontario's annual revenue loss will be in the $70-80 million range.

The total revenue loss in Canada from the fast write-off is estimated at over $500 million in 1973, including both federal and provincial shares. The cost of this incentive peaks in the third year (i.e. 1974) then gradually tapers off in subsequent years.

III COMBINED IMPACT

Revenues

Since these two incentives are highly interrelated, the combined impact is not simply the sum of the individual incentives. The fast write-off provision - the stronger incentive - is offset to some extent by the rate reduction; the additional CCA is in essence taxed at a reduced rate. Alternately, the impact of the CIT rate reduction is cut by an initial 1/3 due to the additional CCA write-off which lowers the amount of taxable income. Neither incentive should be viewed in isolation of their interaction. The total tax savings to corporations resulting from these manufacturing incentives is shown in Table 3.

ESTIMATED TAX SAVINGS RESULTING FROM
TURNER'S INCENTIVES FOR MANUFACTURING & PROCESSING

Manufacturing & Processing Income in Excess of $50,000	ONTARIO CIT ($ Millions)					COMBINED CIT IN ONTARIO ($ Millions)					STANDARD CIT IN CANADA ($ Millions)				
	1972	1973	1974	1975	1976	1972	1973	1974	1975	1976	1972	1973	1974	1975	1976
TAX SAVINGS FROM ADDITIONAL CCA															
Additional CCA claimed	190	575	721	664	627	190	575	721	664	627	362	1093	1371	1262	1192
@ tax rate	.12	.12	.12	.12	.12	.485	.51	.50	.49	.48	.465	.49	.48	.47	.46
equals gross tax savings	23	69	87	80	75	92	293	361	325	301	168	536	658	593	548
TAX SAVINGS FROM RATE REDUCTION															
Taxable Income (@ 10% growth per year)	1648	1812	1993	2192	2412	1648	1812	1993	2192	2412	3014	3315	3647	4012	4413
@ rate reduction							.09	.08	.07	.06		.09	.08	.07	.06
equals gross tax savings							163	159	153	145		298	292	281	265
LESS OFFSET FROM INTERACTION:															
Additional CCA * Rate Reduction							-52	-58	-46	-38		-98	-110	88	-72
TOTAL TAX SAVINGS FROM INCENTIVES	23	69	87	80	75	92	404	462	432	408	168	736	840	785	741

For an individual manufacturing company the rate reduction alone generates tax savings, whether or not the company is expanding. The fast write-off generates further tax savings if the company undertakes new investment in machinery and equipment. The example below shows the tax savings which will accrue to a representative company.

EXAMPLE OF 1973 TAX CALCULATION
BY A MANUFACTURING CORPORATION

	Old System	New System
Manufacturing profits before depreciation	$2,000,000	$2,000,000
Depreciation on existing assets of $10 million	800,000	800,000
Taxable Income	1,200,000	1,200,000
@ federal and Ontario tax rates	.51	.42
equals tax payable	612,000	504,000
tax savings from rate reduction		108,000
Assume new investment	1,000,000	1,000,000
Additional depreciation claimed	200,000	500,000
@ tax rate	.51	.42
equals additional tax deductible	102,000	210,000
tax savings from fast write off		108,000
Total tax payable	510,000	294,000
Total tax savings from both incentives		$216,000

Economic Effects

The fast write-off provision combined with the federal rate decline from 39 to 30 per cent on Canadian manufacturing and processing income only was designed specifically to stimulate long-run growth and investment in the manufacturing sector.

As well, the new incentives constitute a permanent response to recent U.S. policy measures. The fast write-off will partly neutralize the American 7 per cent investment tax credit, and the reduced corporate tax rate more than offsets the incentives of the DISC legislation, without violating any international agreement. The new measures should protect domestic manufacturing in Canada against potential losses to the U.S., and lead to greater efficiency in our manufacturing sector over the long run.

Bonus to Ontario

Since these incentives are intended to promote manufacturing and processing activity, it is expected that particular benefit will accrue to Ontario which has 52 per cent of the eligible investment in Canada, as shown below. Among the industries concentrated in Ontario which will benefit are the auto parts industry, the steel and electronics industries, and beverage companies and food processors. Machinery and equipment used in industries such as metal fabrication, chemicals, electrical products, pulp and paper, and textiles - to mention only a few examples - would also qualify.

ONTARIO'S SHARE OF INVESTMENT
ELIGIBLE FOR THE FAST WRITE-OFF

	Ontario	Canada	Ontario as a % of Canada
Eligible Investment	1,086	2,068	52%
Total Investment	2,957	7,075	42%

Long-Run Shifts

The permanent restructuring of corporate taxation introduced in the May 8 budget will have both positive and negative effects on long-run industrial behaviour. These can be summarized in terms of structural shifts, factor shifts, and shifts in the patterns of industrial concentration and ownership.

- Both CIT incentives create a strong tax bias to shift resources into manufacturing operations and away from other activities.

- The two-year fast write-off encourages the substitution of capital for labour within manufacturing.

- Large companies are more capable of exploiting the new tax incentives hence are likely to increase their share of total manufacturing operations.

- Foreign controlled companies will benefit from the incentives which could involve an increase in the non-resident share of future expansion of manufacturing in Canada and Ontario.